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A Profile of the U.K. Recession

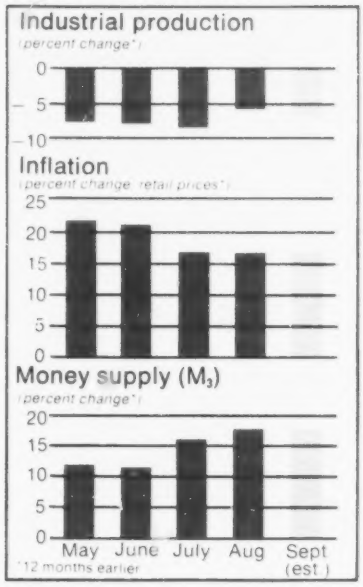
The British economy is now deep into recession. Industrial output has declined steadily over the course of the year (excepting a small uptick in June), and the index of retail sales volume stands at about the level prevailing in 1976. Moreover, the unemployment rate rose to 7.4% in September from 7.0% in August. The recession appears unlikely to reach its trough before yearend, and will result in a decline of slightly less than 2% in real GDP for 1980 as a whole.

The downturn has been accompanied by some good news. The balance of payments has shown a large surplus for the last four months, with export volume holding up well in the face of continuing sterling strength. And the rate of inflation has come down. September retail prices were up some 17% from their year-earlier level, compared with 21.9% in May.

These developments would appear to suggest an imminent reduction in Britain's high interest rates—the Bank of England Minimum Lending Rate (MLR) is now 16%. Indeed, the Thatcher Government is under considerable pressure to ease rates. But such pressure is likely to be resisted, largely because of the alarming increase in the money supply. Sterling M_3 increased by more than 9% from June through September, with the September money stock estimated to be up 18% from its year-earlier level. The supply of credit to the private sector remained reasonably strong under the "corset" lending restrictions, despite the high interest rates. And when the corset restrictions were lifted in June, official figures for credit and the money supply jumped. With the Government's borrowing requirement expected to grow once more after having turned down in September, there will be little scope for significant reductions in the MLR in the near term, at least not before the money supply is brought under control.

The prospects for wage inflation are perhaps the most encouraging on the U.K. scene. Some private wage settlements have come through in single digits, with several more likely over the next few months. And although high wages in the public sector remain a problem, there are signs that the Government is preparing to limit annual public pay raises to a maximum of 10%. There is concern, however, that labor may unleash large new demands once economic recovery is under way. The overall inflation outlook is similarly encouraging, with several qualifiers: Part of the recent reduction in inflation came from an erosion of profit margins, which must eventually be restored, and monetary growth continues rapid. Nonetheless, the success in reducing inflation to date gives the Thatcher Government a badly needed dose of credibility.

Selected U.K. economic indicators



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New French budget underscores commitment to curbing inflation.

The French budget proposals for 1981 signal no change in economic policy. A reduction in inflation remains a priority. To this end, a restrictive monetary policy will be pursued in support of a firm franc. The budget deficit is projected at 29.4 billion francs next year, compared with an expected shortfall of nearly 40 billion francs in 1980. At the same time, however, a series of measures will be implemented to help ease the impact of recession. In each of the next five years companies will be able to deduct 10% of their investment expenditures from taxable profits. Tax thresholds will be raised in line with inflation to protect individuals from real growth in their tax burdens. The Government has already announced a one-time increase in child allowances and pensions costing one billion francs. In addition, a one-billion franc support package has been directed at the export sector. The authorities are hoping that these measures will secure 1.6% real GDP growth in 1981, compared with the official projection of 2.2% growth this year. They also anticipate that inflation will average 10.5% in 1981 and drop to 9.5% by yearend.

Ireland's tight money policy triggers recession, but with little abatement of inflation.

Since December 1979, the Irish Government has been fighting inflation with monetary restraint, having abandoned its previous expansionary policy. The tight money policy has pushed the economy into recession. The latest survey of industry shows that 43% of employers reduced their workforces in August and 59% had orders below their normal levels. So far, the policy seems to have had little impact on inflation, which is still running at an annual rate of about 20%, and which will be fueled further if the new wage agreement is implemented. Present proposals would give workers a wage increase of almost 9% for the next nine months, to be followed by an additional 7% for the following six months. Moreover, if the consumer price index rises by more than 10% between May 1980 and February 1981—a strong possibility—the entire package would be reconsidered. Persisting inflation is hitting Irish trade especially hard, promising a 1980 trade gap of at least $2 billion. Furthermore, the new wage agreement would raise the Government's budget deficit to over one billion Irish pounds, despite the prime minister's promise to hold the shortfall to £896 million. The Government's growing difficulties have triggered rumors of a general election before the year is out.

Iceland afflicted by slower growth, high inflation, and a widening current-account gap.

Iceland's National Economic Institute has issued a new set of forecasts that suggest that real GDP will grow by a little over 1% this year. The Institute projects a current-account deficit rising to 40 billion kroner—some 3% of GDP—because of the sharp rise in import (especially oil) prices. Meanwhile, the country's inflation rate continues high. The cost-of-living index showed a 10% advance in the three months ending in August, despite large subsidies of agricultural prices. The cost of living is expected to rise by more than 50% over the course of 1980, lifting the year-average price level to some 58% above that of 1979. In this context, the Government has prepared its budget for 1981, which parliament will consider this month.

Taiwan's rising oil import costs overwhelm rapid export gains.

Taiwanese merchandise exports in the first half of 1980 were 24.5% above their year-earlier level. Although overall demand in major overseas markets has weakened, owing to recession, political and economic disturbances in Korea, Taiwan's key competitor, have enabled it to increase its market share and penetrate nontraditional markets. Total export earnings this year are expected to exceed $18.5 billion, although merchandise imports are increasing even more quickly, mainly because of rising oil prices. Consequently, Taiwan may incur a small trade deficit this year—the first since 1975—while the current-account balance is likely to shift from a position of slight surplus in 1979 to a deficit of about $1.5 billion. Given Taiwan's substantial reserves and ample international credit lines, the shortfall will be relatively easy to finance. Next year, the anticipated upturn in the world economy should return the trade balance to surplus, but it may take a while longer for the current account as freight charges keep climbing and Taiwanese tourists abroad continue to outspend foreigners visiting Taiwan.

Brazil's inflation battle complicated by shutoff in Iraqi oil deliveries.

Brazil may now be seeing the beginning of a decline in its triple-digit inflation rate. The monthly rate fell to 5.3% in September from a peak of 8.4% in July. Similarly, the 12-month change in the inflation index dropped to 104% in September from its August peak of 109%. The improvement is partly a response to the Government's more highly restrictive policies of inflation control, which brought the rate of money supply growth for the first seven months of the year to well below the rate of price increase. Furthermore, the fiscal budget shifted into large surplus. There is concern that inflation-control may now be complicated by the interruption in Iraqi oil imports, which had supplied 40% of Brazilian needs. But Brazil has three months of oil stocks, and other oil exporters have offered to make up any shortfall. In the interim, gasoline prices have been boosted 18%. The Government continues to hope for an inflation rate of 80% by yearend, but such a goal is overly optimistic.

Peruvian authorities act to curb inflation and ease unemployment.

The civilian government of Fernando Belaunde that returned to power in July is faced with the pressing Peruvian problems of high inflation and widespread unemployment. To bring the country's 60% rate of inflation under control, the authorities are focusing on reducing the excessive amount of foreign-exchange inflows—which have led to sharp growth in domestic liquidity—mainly by stimulating imports. To this end, the requirement for import licenses has been removed, and tariffs have been lowered to an average level of 40%, with further reductions expected. Still, inflation is likely to climb over the next few months, possibly to as high as 70% by yearend, as a result of the removal of subsidies on a number of items. To reduce unemployment, the Government plans to boost public expenditures. This should not pose any serious budgetary burden in view of the Government's comfortable financial position, which follows from two years of tax increases and severe spending cutbacks. A more stimulative fiscal policy, together with the ongoing expansion in nontraditional exports and in the mining (and petroleum) sector may give Peru a real GDP growth rate of about 5% this year.

Sri Lanka pinning economic hopes on spurring foreign investment.

Although buffeted by higher oil bills and rapidly accelerating inflation—fueled in large part by an ambitious government investment program—Sri Lanka has had some success in promoting itself as the new frontier for multinationals. The country's potential attractiveness to foreign investors lies in its abundant supply of inexpensive but productive and trainable labor, political stability, and favorable investment climate. The Jayewardene Government is apparently following the Singapore development strategy of decontrolling prices, floating the currency, liberalizing imports, cutting back consumer subsidies, and providing generous investment incentives. The first interested investors were the textile manufacturers of Hong Kong and Singapore seeking relief from rising costs and protectionist quotas. Major international manufacturers of electronic products have also joined in, and eight foreign banks have set up branches over the last 18 months. Increased foreign investment should help Sri Lanka offset its growing import bill and trade deficit during the next few years; it should also spur the economy to meet the Government's medium-term growth target of 6% per annum in the early 1980s.

Kenya adopts price mechanism to dampen imports and stimulate exports.

Kenya's current-account deficit looks set to expand to well over $600 million this year from $455 million in 1979. Export earnings continue restrained by the weakness in coffee prices; and tea prices are only marginally above those last year. Imports, on the other hand, are climbing steadily. The crude oil import bill could reach $500 million, with earnings from the export of oil products sufficient to offset only part of the jump. Thus, the net oil deficit may hit $300 million, versus $183 million in 1979. Responding to the rise in imports, the Government replaced quantitative import controls with tariffs at mid-year. It also raised the export compensation for all manufactured goods from 10% to 20%. While these measures should have import-dampening and export-promoting effects similar to a currency devaluation, the prospect of import duties contributing to higher domestic prices is likely to negate some of the intended benefits.

Rising Rates Threaten Housing Recovery

The recent rapid rise in mortgage rates has dimmed prospects for a quick housing recovery. Indeed, recently released data indicating that new home sales fell 5% in August may be the first sign of renewed weakness in the barely recovered housing market.

Interest rates on new conventional mortgages have risen about 2¾ percentage points over the last three months; they are currently approaching 15% in some areas. Such an increase implies that monthly payments on new mortgages have increased dramatically. For example, the monthly principal and interest payment on a 30-year, $50,000 mortgage with a 12¾% interest rate is approximately $524. If the mortgage rate rises to 14½%, the monthly payment jumps to $612, an increase of nearly 20%. Since personal income has increased by perhaps about 3% in the past three months, this rise in financing costs will undoubtedly have a depressing effect on housing demand.

Moreover, several mortgage lenders will only extend mortgages to households whose monthly incomes exceed monthly mortgage payments by a certain percentage. Consequently, a number of potential homebuyers who may have qualified for a mortgage at a 12¾% interest rate will no longer qualify at the current level of rates.

The recent jump in market interest rates can also be expected to reverse the improvement in deposit flows to savings institutions—the major suppliers of residential mortgage credit—which occurred in July and August. Much of the increase in deposit flows during the summer represented flows into savings accounts, which are subject to an interest rate ceiling of 5½%. Given the magnitude of recent rises in market interest rates, it is likely that the growth of savings and other deposits subject to fixed-interest-rate ceilings will slow sharply in coming months.

Furthermore, the recent jump in interest rates has already begun to put pressure on the profit margins of these already hard-pressed savings institutions. The average maturity of their assets significantly exceeds the average maturity of their liabilities, and increases in interest rates initially have a larger upward impact on their average cost of funds than on their average return on assets. Given the recent and anticipated future volatility of interest rates, the willingness of savings institutions to make mortgage commitments has diminished in recent months.

On balance, the renewed difficulties in housing finance darken the near-term outlook for housing. And even though housing economists have at times been surprised by the resiliency of the housing market in the face of high and rising interest rates, a healthy housing recovery in the near term appears doubtful.

Asia and Oceania — Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF				
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of credit, lions of
Bangladesh	Prospects for agricultural production uncertain because of serious flooding.	June	+ 15%	9.5	$ 111	Aug.	160	— 61%	0.9	1
Burma	Public-sector investment in manufacturing increases.	July	+ 17%	4.4	134	Aug.	275	+ 38%	7.5	
China, People's Republic	Smaller grain harvest will restrain economic growth over the next 12 months.	June	+ 15%	515.0	510	Mar.	1,918	— 25%	1.4	
Hong Kong	GNP growth of 10% in 1980 appears feasible, despite recession overseas.	June	+ 15%	17.6	3,320	n.a.	—	—	—	
India	Agricultural prospects favorable, but industrial production continues stagnant.	Apr.	— 18%	126.3	194	June	7,077	— 3%	7.8	3
Indonesia	Foreign investment climate improving; approvals of new projects increasing.	Feb.	+ 50%	48.0	323	Aug.	5,836	+ 74%	6.4	
Japan	External economic weakness exacerbating domestic slowdown.	July	+ 25%	1,011.0	8,725	Aug.	22,354	— 8%	1.8	
Korea	Government seeking to consolidate and simplify overexpanded industries.	July	+ 16%	61.1	1,624	July	3,140	+ 21%	1.7	6
Malaysia	Foreign investment and some exports slow because of recession abroad.	Mar.	+ 38%	19.4	1,457	June	4,231	+ 12%	5.2	
Nepal	Continuing drought affects business activity.	May	— 36%	1.8	130	Aug.	176	+ 10%	1.0	
Pakistan	Agricultural growth to slow, but manufacturing to continue fairly strong.	June	+ 32%	21.1	275	Aug.	481	+219%	1.1	3
Philippines	Terrorist bombings worry business, but President Marcos appears firm.	Apr.	+ 33%	29.4	617	Aug.	2,375	+ 15%	3.9	7
Singapore	Wage increases and skilled-labor shortage slow economic growth slightly.	June	+ 50%	8.9	3,790	May	6,093	+ 12%	3.1	
Sri Lanka	Real economic growth expected to fall to 4%-5% in 1980.	Apr.	+ 14%	3.3	226	May	401	— 6%	3.0	3
Taiwan	GNP growth rate sustained at 6%-7%, despite recession abroad.	July	+ 26%	32.2	1,840	July	2,472	+ 24%	2.1	
Thailand	Ample rainfall ensures good crops, providing stimulus to general business activity.	June	+ 35%	27.3	592	Aug.	2,019	— 3%	3.1	2
Australia	Investment boom insulates economy from effects of world recession.	Aug.	+ 22%	119.2	8,266	Aug.	1,473	— 18%	1.4	1
New Zealand	Outlook is for a fairly long period of little or no economic growth.	June	+ 24%	17.5	5,645	Aug.	414	— 34%	1.6	2

Asia

Oceania

Further Decline Seen for Business Spending

Although the huge gains in consumer spending since May have been perceived as heralding the end of the recession, business spending has been weak and is likely to continue so. Nonresidential construction and equipment spending accounts for about 10% of GNP, compared with consumer spending's 65% share, but its cyclical volatility makes it especially important to any economic recovery. The average peak-to-trough decline in real business spending in the past five post-war recessions was three times the decline in real GNP. And swings in inventory investment are even more volatile, accounting for about one-half of the total decline in real GNP.

The high volatility of business spending stems from rational business responses. Businesses formulate capital spending and production plans and maintain inventories consistent with an expected level of sales and profitability. If sales are unexpectedly low, unplanned inventory accumulation occurs, reducing cash flow and adding to financing needs, thereby lowering profitability. To reduce inventories, production plans are scaled back. And with a lower rate of capacity utilization, profitability is further eroded since businesses' high fixed costs are spread over fewer units. With a lower level of sales and income, businesses have neither the need nor the wherewithal for new investment.

Indeed, the business sector has begun to adjust in just this fashion. When the sales slowdown began last January, the ratio of inventories to monthly sales in real terms was 1.58, about the level for all of 1979, indicating that stocks were not excessive. But by May, the ratio hit 1.73, despite production cutbacks that had started in February. Profits plunged to an annual rate of $205 billion in the second quarter from $260 billion in the first. Production dropped 8½% from January to July—bringing capacity utilization to less than 75% in July and August from 84% in January—and real capital expenditures dropped about 4% between the first and the second quarter.

Significant cutbacks in business spending still lie ahead. Despite the sharp rise in retail sales during the summer, the overall inventory-to-sales ratio has fallen only about halfway from its peak to its previous level, suggesting that unless sales continue surging, additional production declines will be needed to bring stocks into line with sales. And if the experience of the previous cycles holds, real capital investment will fall another 4% or so from the second-quarter level. This will further depress activity in the capital goods industry, where production has not yet declined sufficiently to prevent the inventory-to-sales ratio from rising. And sustained low rates of capacity utilization, coupled with renewed increases in interest rates, assure that profits will remain low. Any upturn in business spending cannot be expected before early 1981, subject to the legislative approval of tax relief.

AYMENTS		MONEY AND BANKING							COUNTRIES
MF ill- llars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply (M_1)	exchange rate in U.S. dollars October 8, 1980	change from year earlier	current monetary conditions	
	Foreign private investment to be encouraged in certain priority areas.	June	+ 9%	Apr.	+18%	.0680	+10%	Large increase in domestic credit expected in 1980/81.	Bangladesh
	Trade deficit narrows as terms of trade improve.	July	0	Sept.'79	+14%	.1545	+ 3%	Inflation held to about 10%.	Burma
	Petroleum exports to Japan to fall short of commitments.	n.a.	—	—	—	.6800	+ 2%	IMF boosts Fund quota to SDR 1.2 billion.	China, People's Republic
	Exports of most products continue strong.	July	+15%	June	+51%	.1990	− 3%	Money supply continues rising rapidly.	Hong Kong
	Export drive to be launched; liberal import policy to continue.	June	+12%	Apr.	+13%	.1250	+ 3%	Smaller budget gap eases pressure on monetary authorities.	India
	Net oil and gas revenues may hit $11 billion this year.	Aug.	+19%	Mar.	+40%	.001600	0	Money growth expected to be close to target.	Indonesia
	Factory exports should improve over next 12 months.	July	+ 8%	July	− 2%	.004795	+11%	Strong yen permits some interest-rate easing.	Japan
	Exports stronger, but current-account gap may top $5 billion in 1980.	July	+27%	July	+18%	.001655	−20%	Interest rates cut two percentage points in September.	Korea
	Oil exports support growth and trade surplus.	July	+ 7%	June	+18%	.4710	+ 2%	Inflation rate rises to 8%-10% range.	Malaysia
	Foreign aid expected to cover widening external deficit.	June	+15%	Apr.	+20%	.0840	+ 1%	Drought and higher oil prices lift inflation rate.	Nepal
	Efforts to curb imports and boost exports continue.	June	+11%	June	+17%	.1010	0	Improved fiscal stance eases pressure on central bank.	Pakistan
	Trade gap stabilizing near last year's level.	July	+17%	June	+13%	.1325	− 2%	Exchange rate remains stable.	Philippines
	Trade deficit to widen somewhat this year.	June	+10%	May	+14%	.4760	+ 3%	Strong credit demand putting pressure on interest rates.	Singapore
	Trade deficit to widen, owing to worsening trade terms and strong growth.	May	+30%	Apr.	+25%	.0580	− 9%	Heavy government spending crowds out private sector.	Sri Lanka
	Moderate current-account gap expected this year.	July	+19%	July	+21%	.0275	− 1%	Credit remains restrictive.	Taiwan
	Oil imports expand trade deficit.	July	+20%	Feb.	+19%	.0480	− 2%	Credit remains fairly tight.	Thailand
	Large capital inflows needed to finance investment projects.	June	+11%	June	+13%	1.1750	+ 5%	Monetary policy to remain restrictive.	Australia
	New markets for lamb opening up in Middle East.	June	+18%	June	+13%	.9815	− 1%	Pressures build for faster domestic credit growth.	New Zealand

World Interest Rates

market rates of Oct. 8, 1980; bond yields as of Oct. 3, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	11.80	16.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.50	3.00	8.25
Day-to-Day Money	12.375 Oct. 9	10.50	16.00	8.55	11.625	8.95	18.00	9.50	3.50	11.3125
Treasury Bills 91-day, Middle Rates	11.36	11.50	14.125	12.35	12.64 one-year	n. a.	16.101 115-day	no dealing	no market	6.375 2-month
Commercial Paper prime, 3-month, asked	11.00 finance paper	11.75 finance paper 15% tax w/h	13.56	11.60 Certified	12.125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	12.15	11.70 15% tax w/h	14.6875	11.60 Certified	not traded	9.90	21.50	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	11.22	13.15	12.94	11.432 20% tax w/h	13.46	8.31	16.02	10.42	4.78	9.778
Industrial Bonds prime, long-term, new and old issues, average yield	12.85 Aa Industrials	13.70	13.80	15.33	14.27	8.56	16.33	11.35	5.64	7.33
Bank Short-Term Rate to Best Borrowers (prime rate)	13.50	13.00	17.00	15.75	13.85	11.50	21.00	11.50	5.50	8.50
Bank Time Deposits 3-month	12.00 Cert. of Dep.	11.50 Cert. of Dep.	15.3125	12.50	12.125	8.80	10.75	10.125 large deposits	5.25 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	12.5625	no market	15.375	no market	12.25	8.625	no market	10.125	5.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8554	2.3955	.0345	.2391	.5543	.001165	.5100	.6102	.004797
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.625 *P*	2.75 *D*	.1875 *P*	.1875 *P*	3.875 *P*	11.625 *D*	2.25 *P*	7.25 *P*	2.00 *P*

Eurodollar Deposits
(London, interbank, bid)

Oct. 9	
7-day	12.5625
1-month	13.50
3-month	13.00
6-month	13.00

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	+ .18
U.S.-Canada Treasury Bills	−1.295
U.S.-Canada Finance Co. Paper	−2.210
Eurodollars-U.K. Local Auth. Deposits	− .19

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.625
Over 7 yrs.	13.50
DM Bonds	
7 yrs. and under	8.875
Over 7 yrs.	8.875

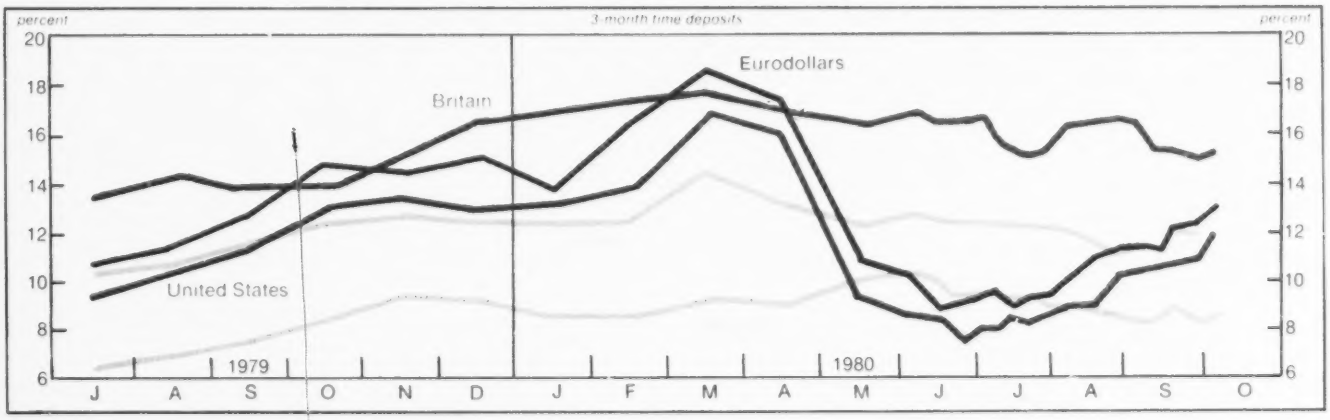
Gold Price

London afternoon fixing

677.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirement.

Interest rate movements in major industrial countries



Portuguese Economic Progress Uneven

The 1970s proved to be a decade of turbulence for the Portuguese economy. In the ten years prior to the revolution of 1974, Portugal's economy was one of the world's fastest growing, with per capita income rising at an average annual rate of 7.1%. Economic policies were conservative and non-interventionist, producing both fiscal and balance-of-payments surpluses.

The 1974 revolution, however, wrought significant economic, as well as political, change. The laissez-faire approach was abandoned, replaced with comprehensive nationalizations, land reform, legalization of trade unions, and the establishment of minimum wages.

By 1975, wages had accelerated sharply, with productivity failing to keep pace. Investment plummeted, as did both exports and imports. Public and private consumption, however, grew substantially. The net result was a current-account deficit of about $800 million in 1975—in contrast to a surplus just two years earlier—and real GDP growth bottoming out at a negative 4.7%.

An economic recovery in 1976-77 saw Portuguese industrial production revive, while wage demands moderated in the face of rising unemployment. The 6.5% real GDP growth recorded in both years, however, was accompanied by a sharply widening current-account deficit and accelerating inflation. A current-account gap of $1.3 billion was posted in 1976, with a year-average inflation rate of 18.2%.

The balance-of-payments stress triggered a 15% devaluation of the escudo against the dollar in February 1977, along with import quotas, tighter price controls, and higher interest rates. These were followed in August 1977 by further monetary tightening and the introduction of "crawling peg" devaluations of 1% per month. Still, 1977 saw a current-account shortfall of $1.5 billion, with a jump in the average inflation rate to 27.3%, partly because of a fiscal policy that continued expansive.

Portugal's pressing need to finance its current-account deficit precipitated heavy international borrowing. Several OECD-member nations agreed to lend substantial sums, subject, however, to Portugal's adoption of a new stabilization program drawn up under the auspices of the International Monetary Fund. The adjustment program unveiled in May 1978—essentially one of monetary restraint and exchange-rate adjustment—called for a further 7% devaluation and a boost in the monthly escudo devaluations to 1.25% for 12 months, higher interest rates and taxes, slower money growth, and a cap on wage increases.

The policies were reasonably successful and produced a slowdown in real GDP growth to 3.2% in 1978. Monetary growth eased, the year-average rate of inflation fell to 22.1%, and the current-account deficit was halved. The program's effectiveness, however, continued hindered by a widening fiscal deficit.

In 1979, the Government's stabilization efforts were rewarded with a small surplus on current account, the first since 1973. It was largely the result of a policy of monetary restraint sustained for most of the year that dampened domestic demand. But an expansive fiscal budget swelled domestic credit late in the year, which combined with higher oil prices to push the average annual inflation rate back up to 24.2%.

The economic scene this year has been overshadowed to a large degree by political uncertainty. The recent victory of the Sa Carneiro Government in the October 5 general elections means that liberalization of the economy is more of a possibility. This would ultimately entail encouragement of private enterprise, a halt to the military's involvement in government, and agricultural and labor-law reform. The presidential election slated for December, however, will decide whether the Sa Carneiro leadership is able to consolidate its power sufficiently to push such policies through.

In the interim, the Government has had further success in battling inflation. The annualized rate has fallen to less than 20% (a year-over-year rate of 17.5% was posted in July), owing to a 6% revaluation and a reduction in the crawling peg devaluations, and higher consumer subsidies. Nonetheless, domestic money growth continues to advance at an annual pace in excess of 35%. This, combined with a number of postponed public-enterprise price rises, promises another upturn in inflation in 1981.

The external accounts have remained relatively healthy this year, despite a rapidly escalating oil import bill. The reasons include record tourism, rapid growth in export earnings, and large foreign remittances. The current account is thus expected to deteriorate only slightly—from a position of small surplus in 1979 to a deficit of between $600 and $900 million.

The hoped-for resurgence of private investment—particularly foreign—appears unlikely under present circumstances, and greater latitude for private-sector activity has been vetoed by the Military Council. Consequently, real GDP growth in 1980 is not expected to reach the targeted 3.5%; it will more likely be in the range of 2½%. Moreover, the new fiscal budget demonstrates that public expenditures have yet to be restrained, with the deficit set to rise to nearly 12% of GDP in 1980, as against 6.9% in 1977.

On balance, Portugal has made substantial economic progress since its adoption of stabilization policies in 1977—in the external-payments area and in the repayment of large amounts of short-term debt. A major challenge is to reduce the underlying inflationary pressures by avoiding overstimulation of the economy; and the key here is to curtail public expenditures.

Peter A. Davies
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The SDR Redefined

The International Monetary Fund recently announced that the currency basket determining the value of the Special Drawing Right (SDR) would be radically altered beginning January 1, 1981. The value of the SDR is currently a weighted average of 16 different currencies, while the new valuation method will use only five currencies weighted as follows:

	Weight (%)
U.S. dollar	42
German mark	19
French franc	13
Japanese yen	13
British pound	13

The actual valuation formula will be computed at year-end. Using average exchange rates for the fourth quarter, the IMF will seek to ensure that the SDR's valuation under both the old and new methods produces similar results on January 1 for the value of the major currencies in SDR terms.

The IMF has presumably redefined the SDR largely to encourage its use in private transactions. While a number of international banks currently accept SDR-denominated deposits, such deposits, relative to total world trade, are miniscule. The failure of the SDR to capture private transactions is partly the result of the inclusion in the 16-currency basket of many currencies that do not have well-developed spot or forward-exchange markets. Neither borrowers nor lenders have available to them a mechanism with which to hedge their SDR exposure. Thus, holders of SDR-denominated assets or liabilities risk an exchange-rate loss that cannot be insured against.

All five currencies in the new basket, however, have active spot and forward foreign-exchange markets. Hence, international investors will soon have an efficient method of hedging foreign-exchange risks associated with SDR exposure. Whether this will make a small or a large difference in the volume of private SDR transactions is not clear, but it will reduce the real costs of using SDR-denominated instruments.

An important feature of the new SDR valuation is that it will be based on the same five-currency basket that is used to compute the interest rate paid by the IMF to its SDR depositors. The IMF computation of the SDR interest rate it pays is based on such instruments as treasury bills and discounted private bills that carry interest rates 50 to 250 basis points lower than the rates on three-month Eurocurrency deposits. Furthermore, the IMF pays its depositors only 80% of the calculated interest rate.

A "Euro-SDR" rate would essentially be a weighted average of the relatively higher Eurocurrency rates. Hence, the rate on SDRs on deposit in Euromarket banks will exceed, by a non-trivial amount, the SDR interest rate calculated by the IMF. This is significant because it is the difference between Eurocurrency deposit rates that is arbitraged against the foreign-exchange forward premium (or discount). Thus, if a forward-exchange market in the SDR developed, its premium (or discount) would reflect the higher Eurocurrency rates, rather than the IMF's interest-rate formula.

This prospect raises the question of whether greater private usage of SDR-denominated instruments will lead, first, to greater competition in international financial markets for SDR business, and consequently, to market pressure on the IMF to pay its central bank depositors a "market" interest rate. Already, the IMF is considering payment of 100% of its calculated interest rate.

Bluford H. Putnam

Eurocurrency Market

($ billion, end of period)

Total Market Size	**IIIQ/79**	**IVQ/79**	**IQ/80**	**IIQ/80**	**1978**	**1979**	**1980**
Gross Size (Claims)	1,041.5	1,110.7	1,117.2	1,118.0	892.7	1,110.7	1,300.0
Net Size (Claims)	635.0	665.0	675.0	710.0	535.0	665.0	785.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	258.9	269.2	274.2	285.0	222.7	269.2	320.0
Liabilities to Private Nonbank Foreigners	65.4	65.7	67.6	72.0	54.8	65.7	75.0
Total Claims on Foreigners	316.7	323.9	324.8	345.4	293.0	323.9	390.0
Claims on Foreign Public Borrowers	39.7	41.5	40.9	42.0	33.9	41.5	50.0
Claims on Foreign Private Nonbank Borrowers	113.0	118.0	118.1	128.0	104.2	118.0	135.0

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.